BEFORE THE
DEPARTMENT OF CORPORATIONS
STATE OF CALIFORNIA

In the Matter of the Desist and Refrain Order Issued to: DONALD E. DOUGHERTY and GROVES MOBILE HOME REAL ESTATE, INC., Respondents.	Case No. 38300 OAH No. L2005050145

PROPOSED DECISION

Ralph B. Dash, Administrative Law Judge, Office of Administrative Hearings, heard this matter on May 24, 2005, at Los Angeles, California.

Karen L. Patterson, Senior Corporations Counsel, represented the California Corporations Commissioner.

James E. Dougherty, Attorney at Law, represented Respondents.

The record was left open until June 27, 2005 for the parties to submit closing briefs. The briefs were timely filed and the record was deemed closed and the matter submitted on that date.

Oral and documentary evidence having been received and the matter submitted, the Administrative Law Judge makes the following Proposed Decision.

FINDINGS OF FACT

1. On April 4, 2005, William P. Wood, acting in his official capacity as California Corporations Commissioner, caused a Desist and Refrain Order to be issued against Respondents Donald E. Dougherty (Dougherty) and Groves Mobile Home Real Estate, Inc., (Groves) for an alleged violation of Corporations Code Section 25210. This statute requires that a person or entity engaged in the sale of securities must be licensed as a securities broker-dealer.

2. Dougherty and Groves are both licensed by the California Department of Real Estate; Dougherty is a broker and is the designated officer of Groves. Respondents have their offices at 5200 Irvine Boulevard, Irvine, California, which is also the location of Groves

Mobile Home Park (Groves Park), a senior mobile home park, where residents must be at least 55 years of age, with certain limited exceptions not relevant here.

3. Groves Park is owned, maintained and operated by The Groves Homeowners, Inc., a California nonprofit mutual benefit corporation (Homeowners Association) originally formed in 1986 to purchase the already existing mobile home park.[1] There are 533 shares of stock[2] in this corporation, based on there being 533 spaces for mobile homes in the park. All 533 spaces are occupied. All but 14 of the shares are owned by residents of the park, the Homeowners Association retaining the remainder. The Homeowners Association charges rent to the tenants of the homes occupying the 14 spaces it owns. All share owners pay monthly dues to the Homeowners Association for maintenance of common areas. Share holders do not pay any rent for the space occupied by their homes.

4. In order to purchase a residence in Groves Park, the buyer must also purchase a share in the Homeowners Association. If the buyer purchases a home from an existing resident, the buyer must purchase that resident's share. Homeowner Association rules prohibit anyone who is not a resident of Groves Park from owning a share; sale of the share to the new homeowner is mandatory when the resident moves out of the park. The sale is not conducted through the Homeowners Association; the buyer and seller deal directly with each other and each may use his or her own real estate broker. The sale price of the mobile home and share is negotiable between the parties. The Homeowners Association has no direct interest in the sale of either the share or the home.[3]

5. The Homeowners Association, from time to time, sets the sale price of its shares. It does this by obtaining an appraisal of the land value of the park and then dividing that amount by 533. The current share price is approximately $88,000; that is the amount the Homeowners Association would charge a prospective owner for the purchase of one of its 14 remaining shares. Typically, residents of the park use the current share price as a benchmark in setting the sale price of their home and share.[4] However, as with the home itself, the share price is negotiable between buyer and seller; the Homeowners Association has no control over the sale price of either the home or the share.

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[1] No evidence was offered as to what, if anything (such as making improvements), the Homeowners Association did other than acquire the property after it was formed and its shares sold.

[2] Each share, or "membership certificate," bears the following legend: "It is unlawful to consummate a sale or transfer of this security, or any interest therein, or to receive any consideration therefore, without the prior written consent of the Commissioner of Corporations of the State of California, except as permitted by the Commissioner's rules."

[3] The Homeowners Association did have an indirect interest in the sale, as Respondents' rent was based on the number of sales Respondents generated. The rent was not based on the sale price of the home and share; it was based strictly on a fixed rate involving the number of sales for which Respondents were responsible. However, since issuance of the Commissioner's Desist and Refrain Order, Respondents' rental arrangement with the Homeowners Association was changed and the rent is now computed based on a percentage of the sales price of the mobile home only. Thus, at the present time, the Homeowners Association does not have even an indirect interest in the sale of the share.

[4] If an owner moves from one home to another within the park, there is no requirement that a share be bought or sold. The share grants the owner the right to live in the park, but not in a designated location.

6. Dougherty generally acts as the sales agent for resident owners. He will often represent both buyer and seller in the transaction. His commission is based on the combined sale price of the home and the share. His commission typically runs between 5% and 6%. Dougherty does not earn a commission on the sale of a share by the Homeowners Association.

7. In a typical sales transaction by a resident where Respondents act as the broker, Dougherty will cause an escrow to be opened, see that funds are deposited and monitor the escrow until it closes, in much the same manner as would a real estate broker involved in the typical sale of a single family dwelling. The seller is require to deposit his or her share in the escrow. Dougherty monitors the transaction to make sure this is done, sometimes going as far as physically picking up the share certificate from the seller and depositing the same in escrow. A law firm[5] takes care of all necessary paperwork with the Department of Corporations regarding transfer of the share to the buyer. The law firm charges a fee of $200 for that service. At the close of escrow, the share is delivered to the buyer.

8. Neither of the Respondents have either applied for or secured from the Commissioner a certificate authorizing him or it to act in the capacity of a securities broker-dealer. The Cease and Desist Order was issued to Respondents based on the Commissioner's determination that by effecting the transfers of the memberships in the Homeowner's Association, and charging a commission therefor, while unauthorized to do so, Respondents had violated the provisions of section 25210 of the Corporate Securities Law of 1968[6].

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CONCLUSIONS OF LAW

1. It is axiomatic that before Respondents can be found to have sold securities without authorization, the first determination to be made must be whether the item sold is a security within the meaning of the law. Section 25019 defines the term "security" as follows:

> 'Security' means any note; stock; treasury stock; membership in an incorporated or unincorporated association; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement; collateral trust certificate; preorganization certificate or subscription; transferable share; investment contract; viatical settlement contract or a fractionalized or pooled interest therein; life settlement contract or a fractionalized or pooled interest therein; voting trust certificate; certificate of deposit for a security; interest in a limited liability company and any class or series of those interests (including any fractional or other interest in that interest),

[5] The same firm which did the original legal work when the Homeowners Association was formed.
[6] All statutory references are to this law, unless otherwise noted.

except a membership interest in a limited liability company in which the person claiming this exception can prove that all of the members are actively engaged in the management of the limited liability company; provided that evidence that members vote or have the right to vote, or the right to information concerning the business and affairs of the limited liability company, or the right to participate in management, shall not establish, without more, that all members are actively engaged in the management of the limited liability company; certificate of interest or participation in an oil, gas or mining title or lease or in payments out of production under that title or lease; put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof); or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency; any beneficial interest or other security issued in connection with a funded employees' pension, profit sharing, stock bonus, or similar benefit plan; or, in general, any interest or instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. All of the foregoing are securities whether or not evidenced by a written document. 'Security' does not include: (1) any beneficial interest in any voluntary inter vivos trust which is not created for the purpose of carrying on any business or solely for the purpose of voting, or (2) any beneficial interest in any testamentary trust, or (3) any insurance or endowment policy or annuity contract under which an insurance company admitted in this state promises to pay a sum of money (whether or not based upon the investment performance of a segregated fund) either in a lump sum or periodically for life or some other specified period, or (4) any franchise subject to registration under the Franchise Investment Law (Division 5 (commencing with Section 31000)), or exempted from registration by Section 31100 or 31101 .

2. Despite this lengthy definition, the courts have uniformly held that in determining whether an instrument is a security within the meaning of the law, one must look through the form and determine the substance or nature of the instrument in question. The facts and circumstances surrounding the transaction, the true intent of the parties, their mutual purposes and expectations and the potentialities of the rights conveyed must be examined. Whether an instrument is a security must be determined on a case by case basis. See, *Oil Lease Service, Inc. v. Stephenson* (1960) 162 Cal.App. 2d at pages 107-108.

3. California courts have generally adhered to one of two different formulae in making a determination as to whether an instrument evidencing ownership interest in a project is a security. They are the "investment contract, common enterprise" test, as defined

in *Securities and Exchange Commission v. W. J. Howey Co.* (1946) 328 U.S. 293 (*Howey*) and the "risk capital" assessment as enunciated in *Silver Hills Country Club v. Sobieski* (1961) 55 Cal. 2d 811 (*Silver Hills*).

4. In *Howey*, a company owned a large tract of citrus acreage. In order to help the company finance additional development, the company kept half of the land and offered the remainder to others. Each prospective customer was offered a land sale contract for a "piece of the property" (the pieces varied in size but generally were under five acres) and a service contract from a company related to the landowner, to cultivate, harvest and market the crops grown on the land. The service company was well established in the citrus business and was given full discretion and authority over all crop related issues. The purchaser had no right of entry to market the crop. The land was sold to each investor under a land sale contract, with a uniform purchase price per acre, the price varying only in accordance with the number of years a particular plot had been planted. Once the land was paid for in full, a warranty deed would be given to the purchaser.

The lower courts had determined that the above transaction did not constitute a security. They treated the land purchase and the service contract separately and found the arrangement was nothing more than the sale of land and an agreement by the seller to manage the property. *Howey* reversed the lower courts and held the transactions in question were not severable, but were part of an investment contract, and thus a security within the meaning of federal law.

Citing other cases, *Howey* first noted that an investment contract meant a plan or scheme "for the placing of capital or laying out of money in a way intended to secure income or profit from its employment." (Id at p. 298.) The court next pointed out that this definition had been "uniformly applied by state courts to a variety of situations where individuals were led to invest money in a common enterprise with the expectation that they would earn a profit solely through the efforts of the promoter or of some one other than themselves." (Id.) The court then applied this law to the facts of the case and found, commencing at page 299:

> The transactions in this case clearly involve investment contracts as so defined. The respondent companies are offering something more than fee simple interests in land, something different from a farm or orchard coupled with management services. They are offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondents. They are offering this opportunity to persons who reside in distant localities and who lack the equipment and experience requisite to the cultivation, harvesting and marketing of the citrus products. Such persons have no desire to occupy the land or to develop it themselves; they are attracted solely by the prospects of a return on their investment. Indeed, individual development of the plots of land that are offered and sold would seldom be economically feasible due to their small size. Such tracts gain utility as citrus groves only when cultivated and developed as

> component parts of a larger area. A common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments. Their respective shares in this enterprise are evidenced by land sales contracts and warranty deeds, which serve as a convenient method of determining the investors' allocable shares of the profits. The resulting transfer of rights in land is purely incidental.
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> Thus all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise. It follows that the arrangements whereby the investors' interests are made manifest involve investment contracts, regardless of the legal terminology in which such contracts are clothed. The investment contracts in this instance take the form of land sales contracts, warranty deeds and service contracts which respondents offer to prospective investors.

5. The facts of this case, as set forth in the above Findings, do not meet the "investment contract, common enterprise" scheme as envisioned in *Howey*. The purchasers of a share in the Homeowners Association are not investors who live far away and rely on others to work the land in order to generate a profit. On the contrary, the purchasers are all residents of Groves Park. While the Homeowners Association maintains the common areas, the share owners pay for this service by separate monthly dues. The profit made, if any, on the sale of their share is related directly to the market value increase in the land on which their mobile home sits, a factor over which no one, not the owners or some third party, has any control. Each owner is free to negotiate his or her own sale price. There is no common enterprise whereby the residents rely on the work of others to improve the land in a manner that affects the market value of their shares, and the shareholders receive no income or profit from the business of the Homeowners Association. Furthermore, there was no evidence that buyers of shares in the Homeowners Association were attracted to make their purchase "solely by the prospects of a return on their investment."

6. *Silver Hills* involved a venture to organize a country club and to conduct it for a profit. After making a down payment and taking possession of the property in question, the owners/petitioners in that case began making improvements, such as planting grass, installing a swimming pool, remodeling buildings and adding showers, a steam room and health and exercise equipment. They financed these improvements, in part, by the sale of memberships in the country club. The member, and his immediate family, had a right to use the club's facilities, except for the yet to be completed golf course, which would require a separate membership fee.

The Commissioner concluded that a membership interest in the country club was a security and issued a Desist and Refrain Order to stop the sale of memberships. In upholding the Commissioner's determination, the *Silver Hills* Court found that the purchase of the

memberships was "attended by the very risks the corporate securities act was designed to minimize." (Id at p. 814) The court went on to note that the definition of "security" was made intentionally broad "to protect the public against spurious schemes, however ingeniously devised, to attract risk capital." (Id) The court then explained, at page 815:

> ...'as a general rule, the sale of "securities" that is condemned by the courts involves an attempt by an issuer to raise funds for a business venture or enterprise; an indiscriminate offering to the public at large where the persons solicited are selected at random; a passive position on the part of the investor; and the conduct of the enterprise by the issuer with other people's money.' (Dahlquist, *Regulation and Civil Liability Under the California Securities Act, supra*, 33 Cal.L.Rev. 343, 360.)
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> We have here nothing like the ordinary sale of a right to use existing facilities. Petitioners are soliciting the risk capital with which to develop a business for profit. The purchaser's risk is not lessened merely because the interest he purchases is labelled a membership. Only because he risks his capital along with other purchasers can there be any chance that the benefits of club membership will materialize.

7. In contrast to the facts in *Silver Hills*, the evidence in this matter shows that the only right conveyed by the share certificate in the Homeowners Association is the right to live in the facility. There is no capital being risked for the chance that the benefits of membership will materialize. Groves Park was and is an existing facility; sale of its shares was and is not for the purpose of developing anything.[7] Furthermore, no evidence was offered that the Homeowners Association was formed "to develop a business for profit." The shares at issue here do not meet the *Silver Hills* risk capital test.

8. It is found that the shares at issue do not meet either the *Howey* or the *Silver Hills* criteria and thus are not securities within the meaning of the law. Accordingly, Respondents did not have to be licensed by the commissioner in order to effect the sale of shares, and there is no rule or regulation promulgated by the Commissioner which would preclude Respondents from receiving commissions based on the sale price of the shares.

9. Even if the shares were determined to be securities, Respondents nevertheless would be permitted to facilitate the sale thereof and receive a commission thereon. That is because the sale of the share is strictly incidental to the sale of a home in Groves Park. One cannot buy a share without also buying a home in the park. All shareholders must be park residents. In *Lyons v. Stevenson* (1977) 65 Cal.App. 595 (*Lyons*), the issue, as framed by the court at page 602 was "whether a real estate broker may recover a commission on a transaction that involves the transfer of securities." The court answered this question in the

[7] Although not specifically addressed by the evidence, testimony at the hearing and reasonable inferences drawn therefrom lead to the conclusion that the original shareholders formed the Homeowners Association so they could purchase the land and not thereafter have to pay rent for the space their units occupied.

affirmative. *Lyons* went through an extensive analysis of California case law in coming to this conclusion. In citing *Weber v. Jorgensen* (1971) 16 Cal.App. 3d 74, *Lyons* made particular note of the following, at page 601:

> The court in *Weber* stated, although plaintiff knew that the real estate transaction would result in the transfer of securities . . . The court accepted the rule that a contract to sell corporate shares made by a person without the required certificate from the Corporations Commissioner is illegal. (*Id.*, at p. 84.) And where the conduct of a broker brings him within the proscription of the Corporate Securities Law, his contract will not support an action to recover compensation for his services. (*Id.*, at p. 84.) After setting forth the above principles the court stated: 'However, such rules denying relief to parties to illegal contracts are subject to a wide range of exceptions. In each case, the grant or refusal of relief depends upon the public interest involved in the particular kind of illegality, including the policy of the transgressed law. (See, 6A Corbin, Contracts (1962), § 1534, pp. 818-819.) 'In each such case, how the aims of policy can best be achieved depends on the kind of illegality and the particular facts involved.' (*Lewis & Queen* v. *N. M. Ball Sons* (1957) 48 Cal.2d 141, 151 [308 P.2d 713].)

Lyons further developed the public policy theme regarding exceptions to the requirement that sales of securities may only be effected by licensed securities brokers. The court stated, at pages 602-603:

> From *Weber, Stoll, Nationwide*, and *Owen*, the following principles can be derived regarding a person who is not licensed as a securities broker: (1) If a real estate broker in procuring a buyer for a 'business' is unaware that the transaction will be effectuated through the transfer of stock and does not participate in the negotiations surrounding the actual transfer, he may recover compensation for his services; (2) a real estate broker may still recover compensation for his services although he knows the transaction will result in the transfer of securities, if the transfer of the securities is 'incident to' the sale of real or personal property; (3) a real estate broker may not recover a commission if he is employed specifically to sell or purchase securities; (4) if a person is neither licensed as a real estate broker nor a securities broker and contracts to negotiate a securities transaction, he may not recover a commission.
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> In the first two situations the agreement by which the real estate broker is retained is essentially and primarily one to sell a business or property. In the latter two situations, a real estate broker or one holding no license is retained primarily to negotiate a transfer of securities. Thus, it can be said that there is a 'public policy objection' to the nature

> of services rendered if the nature is primarily to negotiate a transfer of securities. In the case at bar plaintiff knew that Sather Gate Mortgage Company was a corporation and therefore stock existed. But, neither plaintiff nor defendant considered the method by which the 'business' would be transferred. Nor was plaintiff specifically retained to sell securities. Therefore, plaintiff was primarily retained to sell a business or property and not securities and there is no 'public policy objection' to his recovering a commission.

It is no stretch of the *Lyons* analysis to determine that Respondents here sold the shares in question "incident to" the sale of the mobile homes (item 2 noted in *Lyons.*) Respondents only earned commissions when they sold a mobile home, even though the sale of the home was coupled with the sale of the share and the commission was based on the combined sale prices of the home and the share. If the Homeowners Association sold one of its retained shares, such as to an existing tenant, Respondent received no commission from the sale of the share; rather his commission was based on the price of the home only. Clearly, Respondent was not employed specifically to sell securities (item 3 in *Lyons.*) Thus, Respondents' receipt of a commission based, in part, on the sale price of the share does not violate public policy.

9. Based on the foregoing legal conclusions, the Desist and Refrain Order must be vacated.

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ORDER

WHEREFORE, THE FOLLOWING ORDER is hereby made:

The Desist and Refrain Order issued to Respondents Donald E. Dougherty and Groves Mobile Home Real Estate, Inc. on April 4, 2005 is vacated.

Date: 7-26-05

RALPH B. DASH
Administrative Law Judge
Office of Administrative Hearings